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IN THE UNITED STATES BANKRUPTCY COURT

DISTRICT OF ARIZONA

In Re: Baptist Foundation of Arizona, an Arizona nonprofit 501(c)(3) corporation, and related proceedings, Debtors,	Chapter 11 Case No. 99-13275-ECF-GBN through 13364-ECF-GBN **FRIEND'S OBJECTION TO PLAN CONFIRMATION**

Harold D. Friend objects to confirmation of the First Amended Joint Liquidating Plan of Reorganization (“Plan”), individually and on behalf of the following creditors in which he directly or indirectly holds a controlling interest: Property Consultants, Inc. (“PCI”), Stockbridge Realty Investors-Arizona, Inc. (“SRI”), Stockbridge Holding Company (“SHC”), Export Tyre Holding Company (“ETH”) and HMR, Inc. (“HMR”)(collectively “Friend Entities”).

The Plan Proponents have obviously worked hard to prepare a careful and thorough Plan that meets the concerns of most parties in interest in this case. The result is worthy of admiration and praise. But significant flaws remain. The Plan does not comply with the applicable provisions of the Bankruptcy Code, as required by Code § 1129(a)(2); the

Friend Entities do not receive as much as they would if the bankruptcy estates of the various estates were liquidated under chapter 7, as required by §1129(a)(7)(A)(ii); the Plan discriminates unfairly against the Friend Entities and is not fair and equitable as to them, as required by §1129(b)(1). The combination of substantive consolidation and release of equitable subordination causes of action on the Friend Entities' claims, and the abolition of liquidated indemnity claims, render the Plan unconfirmable.

I. The Plan Prevents Tort and Contract Creditors from Recovering Against Assets Owned by Their Debtors.

Under the Plan, all the property owned by all the Debtors is commingled and used to pay the claims of all the Debtors. Real estate developments described as Westside Land, for example, owned by STG subsidiaries, will be sold by the Trustee and the proceeds used to pay creditors of Debtors other than the property-owning Debtors (Discl. Stmt. p. 41, 67-68). The investor creditors share pro rata in all recoveries, as adjusted to account for their collateralized or non-collateralized status (Plan ¶5.4.3).

Tort and contract creditors are treated differently. They recover a percentage of their claims in accordance with percentages set forth in a General Unsecured Claims Recovery Schedule. Neither the Plan nor the Disclosure Statement explains how the percentages are derived. The Disclosure Statement does represent that tort and contract creditors "will be dealt with in accordance with the recoveries they would have received from a liquidation of the Debtor entity or entities to whom they extended credit" (Discl. Stmt. p. 63). In other words, the tort and contract creditors are to be paid only if their particular Debtor is deemed solvent. If so, they have an opportunity to receive full payment over two years. If not, they receive nothing (Plan ¶5.6.2).

The Claims Recovery Schedule calculations are made, however, by taking into account the inter-company debt that is extinguished under the Plan, and refusing to equitably subordinate that debt. The computations also appear to take into account purportedly secured debt of the "Collateralized Investors" even though no deeds of trust or other security interest documentation was recorded with respect to the properties owned by the various Debtors.

The Friend Entities' claims are primarily for breach of commission and brokerage fee contracts on real properties. At least in the case of the Debtors owning those properties, the estate asset values are significant. The estates are not abandoning the assets as valueless; the Disclosure Statement touts them as the source of unsecured creditor claim payments (Discl. Stmt. pp. 38-41, 67-68).

But the General Unsecured Claims Recovery Schedule does not list tort and contract creditors of the property-owning Debtors as receiving payment in full. Equity Capital Investors' creditors are to receive only 56% on their claims, and STG creditors receive nothing (Docket 915). Most of the Debtors owing money to the Friend Entities are subsidiaries of STG that are not listed in the Schedule; presumably their creditors are to receive a 0% recovery like creditors of their parent STG.

The only way STG subsidiaries can be deemed unable to pay their third party claims in full is through including inter-company debt in the calculation, and for some

Debtors also treating "Collateralized Investor" debt as if it were perfected by mortgages or trust deeds, and payable before unsecured claims. If the estates were not substantively consolidated, that debt would certainly remain. But it would be subject to equitable subordination by the third party tort and contract creditors, and avoidance of unperfected liens. The Plan eliminates such equitable subordination and settles the Collateralized Investor perfection issues, in language is broad enough that it appears to eliminate 11 U.S.C. § 544 claims as well as § 510(c) claims (Plan ¶ 6.19). There is nothing wrong with settling and terminating such claims under the Plan IF they are not deemed settled and extinguished for purposes of determining payments to tort and contract creditors.

II. Abrogation of Equitable Subordination Renders Substantive Consolidation Unfair and the Plan Unconfirmable.

A. Substantive Consolidation is Not Supposed to Adversely Affect Creditors.

The Plan Proponents recognize that substantive consolidation should not adversely affect unsecured creditors. "The primary purpose of substantive consolidation 'is to ensure the equitable treatment of all creditors.'" *Alexander v. Compton (In re Bonham)*, No. 98-36081, 2000 U.S. App. LEXIS 24799 at *22 (9th Cir. Oct. 4, 2000) (quoting *Union Savings Bank v. Augie/Restivo Baking Co. Ltd. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 516-517 (2d Cir. 1988)). Despite its primary purpose, substantive consolidation typically changes the rights of some parties: "There are winners and losers in the process. The creditors of the poorer estates may benefit from the pooling of assets of a more solvent estate, and those from the more financially solvent estates will be diluted." *In re*

Bonham, 226 B.R. 56, 76 (Bankr. D. Alaska 1998), *aff'd by Alexander*, 2000 U.S. App. LEXIS 24799. Consequently, "substantive consolidation should be sparingly used, with an eye to possible negative effects on creditors." *In re Bonham*, 226 B.R. at 59.

Here, the Plan Proponents readily acknowledge their "goal is to promote fairness to Investors" (Discl. Stmt. p. 64). They purport to eliminate the inequitable redistribution of recovery for general unsecured creditors that would otherwise accompany substantive consolidation. The Plan provides that "[s]ubstantive consolidation shall have no effect on Allowed General Unsecured Claims…." (Plan ¶ 2.3.2). It seeks to accomplish this result by providing for contract and tort creditors to be paid the same amounts they would receive if the estates of their respective Debtors were not substantively consolidated. This approach to eliminating the prejudicial effects of substantive consolidation is laudable. However, the implementation is flawed because equitable subordination and avoidance claims are eliminated too.

B. Unsecured Creditors Have Equitable Subordination Claims Against Inter-Company Creditors and Claims to Avoid Unperfected Liens

In a Chapter 7 liquidation, tort and contract creditors would be entitled to pursue equitable subordination of inter-Debtor Claims. In all likelihood they would succeed, for the same reasons the Restructuring Committee and Creditors' Committees and Investors' class action counsel have acknowledged all along – the Debtors' serious misconduct resulted in insufficient money to pay their creditors. *See* Code § 510(c)(1). *See also Paulman v. Gateway Venture Partners III, L.P. (In re Filtercorp, Inc.)*, 163 F.3d 570, 583

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(9th Cir. 1998) (listing requirements for equitable subordination as 1) inequitable conduct by a claimant; 2) injury to competing claimants or unfair advantage to the claimant; and 3) consistency with bankruptcy law); *Stoubmos v. Kilimnik*, 988 F.2d 949, 960 (9th Cir. 1993) (holding that bankruptcy court abused discretion in denying equitable subordination of claims where self-dealing transactions prejudiced other creditors); *Cennamo v. United States (In re Cennamo)*, 147 B.R. 540, 544 (Bankr. C.D. Cal. 1992) ("classic case of equitable subordination" involves "inequitable conduct by the claimant resulting in injury to other creditors").

Likewise, in a chapter 7 case, the trustee would exercise 11 U.S.C. § 544 rights to avoid unperfected security interests in estate assets. The Debtors have repeatedly informed the Court that the security interests purportedly documenting the Collateralized Investors' claims were not perfected through recording deeds of trusts and financing statements, and the public record so reflects.

Equitable subordination and pursuit of avoidance actions would allow the Friend Entities, along with the other tort and contract unsecured creditors, to receive larger recoveries from some entities, such as Equity Capital Investors, and some recovery from the STG Debtor entities. If the claims of other Debtors, those which are owed money by the STG Debtors, are subordinated, there would be money to pay third party creditors from the proceeds of their asset sales. If unperfected liens are avoided, third party unsecured creditors could be paid.

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C. The Plan Does Not Meet the Best Interests Test.

It is axiomatic that a Plan which provides creditors with less than they would receive in a Chapter 7 liquidation cannot be confirmed over the objection of the creditors. *See* Code § 1129(7)(A)(ii). Assessing the liquidation value of a debtor requires an analysis of a hypothetical Chapter 7 case. *See, e.g., In re Sierra-Cal*, 210 B.R. 168, 172 (Bankr. E.D. Cal. 1997). The analysis "requires application of the Chapter 7 distribution scheme, *taking into account such matters as subordinations* (11 U.S.C. § 510) and recoveries from general partners (11 U.S.C. § 723) that would be applied in a chapter 7 liquidation." *Id.* (emphasis added).

Here, where the facts present a textbook case for equitable subordination and purported lien avoidance, the Debtors cannot ignore the effect of subordination and avoidance on creditor recoveries in a liquidation. Because the Plan inaccurately assesses what the Friend Entities would recover in a liquidation, it does not satisfy the best interests of the creditors test. Confirmation must be denied for this reason alone.

D. The Plan Unfairly Discriminates Against the Friend Entities and the Other Tort and Contract Creditors.

The Bankruptcy Code's prohibition on unfair discrimination "requires that a plan 'allocate value to the class in a manner consistent with the treatment afforded to other classes with similar legal claims against the debtor.'" *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 787 F.2d 1352, 1364 (9th Cir. 1986) (quoting 5 Collier on Bankruptcy ¶ 1129.03 (14th Ed. 1977)). Plans discriminate unfairly when they single out "the holder of some claim or interest for particular treatment." *Oxford Life Ins. Co. v. Tucson Self-Storage, Inc. (In re Tucson Self-Storage, Inc.)*, 166 B.R. 892, 898 (9th Cir. B.A.P. 1993). Plans that propose "widely disparate treatment of similarly situated creditors" may be rejected as unfairly discriminatory. *Id.*

Here, the Plan discriminates unfairly between classes of creditors. It denies equitable subordination rights to all classes alike. But it eliminates the need for equitable subordination with respect to classes of investor claimants by enabling them to share in the assets of all debtors. The tort and contract creditors do not have that compensating benefit.[1]

The Plan also discriminates against tort and contract creditors of Debtors having substantial inter-company debt in favor of those whose Debtors hold inter-company receivables. Elimination of equitable subordination bestows a significant benefit on creditors of those Debtors, taken from the pockets of those whose Debtors have inter-company payables.

Typically, creditors of less solvent entities *benefit* from substantive consolidation. *See In re Bonham*, 226 B.R. at 76. Here, however, because the Plan artificially limits the recovery of creditors of those Debtors most laden with inter-company debt, with no possibility for equitable subordination, these creditors actually end up in a worse position. The unfairness is exacerbated by the corresponding benefit enjoyed by creditors of those

[1] The assets of all Debtors are commingled so proceeds of assets from various estates may actually be used to pay any one estate's tort and contract creditors, but their recovery amount is determined as if there was no sharing.

Debtors laden with inter-company receivables that cannot be equitably subordinated. The Plan provides no justification for this inconsistent allocation of value among otherwise similarly situated unsecured creditors.

The discrimination is particularly unfair as to the Friend Entities. The bulk of the Friend Entities' claims are for commissions and fees that have been earned in part already, and would have been fully earned but for the Debtors' breach of contract, with respect to specific real properties. Every one of those properties is listed in the Disclosure Statement at pages 37-41 as a valuable asset to be sold by the Liquidating Trust. The Friend Entities assisted in the acquisition of some of those properties at below-market rates. They did the zoning and entitlement work to make the properties saleable, marketed them, and sold some $42 million of lots.

The properties can certainly be sold by the Liquidating Trustee, but the proceeds should be used at least in part to pay the creditors whose services gave them value. The Friend Entities enabled the Debtors to earn significant cash flow, with sales proceeds exceeding actual land acquisition, development and sales costs. The only reason the particular Debtor entities owning the land may be considered to have a negative liquidation value on the petition date is the inter-company indebtedness placed on them by Debtor entities, against Friend's advice (and for some Debtors, the unperfected purportedly secured claims of Collateralized Investors).

The Friend Entities' reward under the Plan is to receive reduced and in some cases no recovery. Instead, the Plan takes the value created by the Friend Entities and distributes it among creditors of other estates, not burdened with substantial inter-company debt. It takes that value and distributes it to the Collateralized Investors with unperfected liens. Neither a rationale nor a need for this treatment appears in the Plan.

III. The Plan Improperly Abrogates Indemnity Claims

The Plan rejects indemnification provisions in contracts, and disallows all indemnity claims, supposedly on grounds of contract rejection and Bankruptcy Code §502(e) authorization (Plan ¶7.1.7). First, the Fifth Circuit has expressly addressed the procedural notion advanced by the Plan Proponents: "The Code and the Rules do not envision the use of a plan as a means for objecting to proofs of claim." *In re Simmons,* 765 F.2d 547, 553 (5th Cir. 1985)(claim cannot be terminated through a plan). The burden of proof on objections to indemnification claims, like other claims, is higher than a simple assertion the claims do not exist. *In re Hemingway Transport, Inc.*, 993 F.2d 915, 924 (1st Cir. 1993); *In re Holm*, 931 F.2d 620, 623 (9th Cir. 1991).

Second, unless the claim of the Friend Entities is completely disallowed, Code § 502(e) does not disallow indemnity claims to the extent they are not contingent at the point when claim allowance is determined by the Court. 11 U.S.C. §502(e)(1)(B). By overriding this Code provision, the Plan fails to comply with the Code, and cannot be confirmed. 11 U.S.C. § 1129(a)(2).

To the extent Friend or the Friend Entities have indemnity or subrogation claims for attorneys' fees and costs that have been incurred or paid, the Debtors cannot simply disallow them under the Plan. *See In re Christian Life Center*, 821 F.2d 1370 (9th Cir.

1987)(order subordinating corporate officer's indemnity claim for defense litigation fees and costs reversed).

Third, to the extent the indemnification claims arise on account of criminal actions against Mr. Friend, Code § 502(e)(1)(B) does not apply. *In re Wedtech Corp.*, 85 B.R. 285, 290 (Bankr. S.D.N.Y. 1988). Those indemnity claims are allowable as long as Friend acted in good faith, as the by-laws of the various Debtor entities require. *Id.* The Court will need to estimate the claims under Code §502(c)(1), but the Plan cannot simply eliminate the claims.

Fourth, rejection of by-laws cannot serve as a basis to circumvent indemnity claims. Indemnification obligations are not executory contracts. *In re THC Financial Corp.*, 686 F.2d 799, 803 (9th Cir. 1982). Mr. Friend's service as an officer and director of several STG subsidiary Debtors ended prepetition. He completed his side of the agreement prepetition, and the only remaining obligation is on the Debtor corporations to indemnify him.

Mr. Friend and the Friend Entities do have such claims against the STG subsidiary Debtors, and have asserted them in their proof of claim. Their indemnity claims are based on contractual provisions as broad and encompassing as allowable under applicable Delaware law. Friend agreed to serve as president of specific subsidiaries of Debtor STG that were established to own, develop and sell real estate on the westside of Phoenix. Those companies indemnified him for all claims made against him in that capacity, and all costs and attorneys' fees incurred in the defense of such claims. Friend also received comparable indemnities from other Debtor entities for which he worked on real estate development deals, including Santa Fe Trail Ranch, Juniper Ridge and MCF.

Friend not only performed services for those entities in good faith, but made money for them. The Debtors now claim that the money Friend generated through operations of these entities resulted in BFA's apparent solvency, and enabled BFA to solicit investments (without any Friend involvement). But however BFA may have misused the money generated by Friend and the Friend Entities, and misrepresented its financial status, Friend did his job and did it in the good faith belief that he was benefiting BFA and its charitable causes by helping it and its affiliates to earn money. He is thereby entitled to indemnification for not only claims against him, but also attorneys' fees and costs incurred in defending himself from those claims. *See, e.g. Witco Corp. v. Beekhuis*, 38 F.3d 682, 691 (3d Cir. 1994)(breadth of interpretation of indemnification rights); *Heffernan v. Pacific Dunlop GNB Corp.*, 965 F.2d 369, 375 (7th Cir. 1992)(same).

Since the Debtors first raised their allegations about Friend and the Friend Entities shortly before the bankruptcy case filing (terminating the Friend Entities' brokerage and consulting contracts), through October 2000, their attorneys' fees and costs responding to the Debtors and to the Investors' class action and opt-out lawsuit allegations totals at least $298,089. The amount will undoubtedly be higher by the time allowance of the Friend and Friend Entities' claims is tried to this Court.

The liquidated indemnity claims are properly included in the Friend and Friend Entities' claims. That amount would be payable in the event of a chapter 7 liquidation.

The Plan violates the confirmation requirement of compliance with all Code provisions by abrogating such claims. 11 U.S.C. § 1129(a)(2).

III. Substantive Consolidation Cannot Be Approved When it is Unfair to Creditors.

The Plan is intertwined with and dependent on Debtor's proposal to substantively consolidate all of the Debtor entities. Therefore, Debtors must satisfy both the requirements for plan confirmation and the requirements for substantive consolidation. *See, e.g., In re Silver Falls Petroleum Corp.*, 55 B.R. 495, 497-498 (Bankr. S.D. Ohio 1985) (denying plan confirmation where Debtors not entitled to substantive consolidation); *In re N.S. Garrott & Sons*, 48 B.R. 13, 17-19 (Bankr. E.D. Ark. 1984) (same).

The Friend Entities recognize that substantive consolidation may be appropriate in this case. However, substantive consolidation must be applied in a manner consistent with its "primary purpose" of ensuring "the equitable treatment of all creditors." *See Alexander*, 2000 U.S. App. LEXIS 24799 at *22. The court must conduct "a searching review or the record, on a case-by-case basis," to "ensure that substantive consolidation effects its sole aim: fairness to all creditors." *Id.* at * 25 (quoting *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp., Inc.)*, 810 F.2d 270, 276 (D.C. Cir. 1987). Thus, the court must examine whether substantive consolidation "appears to work in the particular circumstances of these debtor and their creditors" and should "tailor [substantive consolidation] to the facts of the particular case." *In re Standard Brands Paint Co.*, 154 B.R. 563, 573 (Bankr. C.D. Cal. 1993).

Here, although Debtors have attempted to tailor substantive consolidation to the needs of the case, their proposal is not fair to the tort and contract creditors of the Debtor entities most burdened with inter-company debt. Debtors' attempts to make substantive consolidation *more* fair actually make it less so for the tort and contract creditors. Absent the Plan's substantive consolidation and abrogation of equitable subordination claims, the Friend Entities could subordinate inter-company claims against their Debtors and recover substantially more than the allocations listed in the Plan. Rather than recognizing this possibility, the Plan forecloses it, by locking the Friend Entities into recovery amounts based on the continued existence and non-subordination of that inter-company debt.

"In the final analysis the main requirement for substantive consolidation is that the rights of no creditor or interested party be prejudiced." *In re Stevenson*, 153 B.R. 52, 53-54 (Bankr. D. Idaho 1993). The proposed Plan cannot pass this final analysis. The particular variation on substantive consolidation on which it depends is neither fair nor equitable as to the Friend Entities. Like the Plan itself, substantive consolidation therefore cannot be approved.

Dated: November 7, 2000.

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